Development Partners Working Group on Local Governance and Decentralisation

DPWG-LGD

Study on Fiscal Decentralisation

Summary

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1 Introduction

Since the beginning of the 1990s, most developing countries have embarked in a process of subsequent decentralization, combining political, administrative and fiscal aspects. In this context, the Secretariat of the Development Partners Working Group on Local Governance and Decentralisation (DPWG-LGD) has commissioned a desk study in the area of Fiscal Decentralisation with a focus on local taxation, in order to produce recommendations on two levels: (i) Simplification and optimisation of fiscal systems and (ii) harmonisation of development partners' interventions.

The desk study has been conducted by an individual consultant from Germany and used sources of information provided by the working group members as well as other sources from her professional experience. Reference is made to positive as well as negative experience in a range of countries*,* including some highly decentralised states such as RSA, Colombia, India and the Philippines. With regard to revenue generation at sub-national levels, the focus is on Real Property Tax and market fees and taxes. Selected examples regarding innovative modalities for sub-national borrowing and public-private partnerships are also analysed.

2 General Challenges for Decentralisation in Developing Countries

Decentralisation is a longer-term gradual process that involves, within an appropriate legal framework, various components, such as political decentralisation, administrative decentralisation and fiscal decentralization. All three components need to be present. However, the mix of the components may vary and, consequently the prevailing situation may have a bias towards *de-concentration,* or, when all three components are present, the features of *devolution.* Sometimes, privatisation and deregulation at sub-national level are also regarded as a dimension of decentralization.

Fiscal decentralization generally refers to the *devolution of taxing and spending powers* from the control of central government authorities to government authorities at sub-national levels (regional, provincial, municipal, etc). In a very decentralized system, local governments have considerable power to mobilize resources, through taxing authorities accompanied by strong tax bases.

Generally, the devolution of functions and expenditure responsibilities goes along with (or is followed by) the deconcentration of public services and local elections, which shall allow local governments to function. Most countries on the way to fiscal decentralisation have started to develop a (more or less complex) set of *legal reforms* including e.g. a local-government code, local government revenue legislation including a tax code, a new budget law and a treasury law which need to be consistent with the preferred structure of fiscal federalism in the country. *Assumed benefits* of decentralisation relate to:

- the principle of subsidiarity
- improved governance, accountability, democratization and citizen participation
- Increased efficiency with regard to service delivery

There seems to be no agreed overall model for the implementation of decentralization. The states of the world are structured in many different ways. In

most countries of the north, the structure of fiscal federalism resulted from historical events rather than as a result of design. The same applies to developing countries. This makes cooperation in establishing decentralization frameworks as well as donor harmonization challenging.

The lack of willingness of the centre to relinquish power has been a major impediment to decentralisation and possibly more constraining than the creation of an appropriate legal framework. Therefore, the fundamental challenge for good governance in Africa is to strengthen the political will in support of decentralisation. In many African countries, clear constitutional principles as well as legislative and regulatory frameworks, which are key for decentralisation, are not yet in place. However, there are *successful examples* of comprehensive legal frameworks, among least developed countries as well as middle-income countries (e.g. Rwanda, Philippines).

Major *challenges* relate to the implementation of decentralisation: The different dimensions of decentralisation must be developed in a *balanced manner* in order to become effective: (i) if functions are assigned to local governments these need to be elected, (ii) if governments have been elected, they need financial resources to comply with their functions, (iii) if resources are assigned and transferred, these need to match the expenditure assignments. However, this does usually not occur.

Contrary to this, decentralisation around the world is being accompanied by different kinds of *imbalances*, which reflect an exaggerated focus on either the revenue side, the political dimensions or the administrative dimension, while neglecting others. this implies *risks* for success: If the financial resources and fiscal competencies assigned to local governments do not match their tasks and responsibilities, rising demands in infrastructure and public service delivery cannot be met. The same is true if local governments lack the necessary capacities to effectively make use of the available resources and competencies assigned. If effective internal and external control mechanisms for local governments are absent, transparency and accountability cannot be established, which opens room for corruption and misspending of funds.

Further, sub-national planning is often affected by parallel top-down and bottom up processes, which cannot produce technically comprehensive well-budgeted plans with a satisfactory amount of citizen consultation. The modern concepts of transparency and accountability clash with traditional "governance". In countries, where elected local governments are new, the understanding of public goods and public interest is often not well developed and civil society organisations are not yet able to play a watchdog or advocacy role.

Most local governments are presently delivering only a small part of the *services* of the total that they are supposed be responsible for. This is particularly valid for rural municipalities and emerging cities. While services are poor, and there is little inclination with the public to pay for them. On the other hand, when no payments are received for services delivered, local government is not in a position to improve these services, even if they are entitled to establish cost recovery charges. This is particularly true for services, which require a huge prior investment.

3 Balancing Intergovernmental Fiscal Relations

In the design of a decentralized system of intergovernmental finances, there is an obvious need for a policy decision on concrete *assignment of expenditure responsibilities*. Although, there is no absolute best way for deciding which level of government should be responsible for particular public services, municipal services as well as basic education and health can usually be provided better at the local level, while other functions usually can be provided better at the central government level. Current Problems with expenditure assignments relate to: (i) Lack of Formal Assignments or fragmentation of responsibilities, (ii) Inefficient Assignments and (iii) overambitious attribution of functions to sub-national governments.

The *assignment of taxes* is closely related to the assignment of expenditure functions. Generally, taxes should be assigned to the lowest level of government that can implement it. There is consensus that for sub-national governments it is appropriate to rely on property taxes, commercial or business licenses and local retail sales taxes. Under *full fiscal autonomy*, sub-national governments can choose the taxes they levy, define the tax base(s), set the tax rate(s), and administer the tax(es). In reality, sub-national tax autonomy has often remained limited and capacity to develop existing competences is weak as well. Autonomy in certain areas (such as market fees and taxes) has proven to be vulnerable to inconsistency, duplication of effort, and excessive complexity. Accordingly, in most partner countries, the amount of locally generated revenue is minimal compared to the functions assigned, except for some metropolitan areas.

Experience across regions indicates that the potential benefits of both decentralisation in general, and fiscal decentralisation in particular, will only materialise if intergovernmental fiscal relations are supported by substantial *vertical and eventually horizontal transfers* to local governments in order to compensate for the lack of locally generated revenue and provide stability, equity and efficiency. These transfers can take many forms, with a varying degree of control, conditionality and equalization, including (i) revenue sharing of centrally collected taxes, (ii) conditional grants (e.g. for specific sector purposes or for investment purposes in general), (iii) unconditional grants (for recurrent expenditures or other not-specified investment).

Formulae for grants to sub-national government are mostly based on the idea that (i) districts with a higher population and a larger surface area deserve a higher allocation; (ii) districts that are poorer deserve a higher allocation. In some countries, further aspects are added: (iii) that districts that improve their local revenue collection (as compared to the previous year) deserve a bonus; and finally (iv) that districts which have a larger gap between what they locally collect and what they need for staff expenditure deserve a large allocation. In addition, it is often requested that formulae were simple and transparent.

However, experience of several countries has shown that the design of the perfect equalization formula is an impossible undertaking. A simple formula cannot take all requirements into consideration, while complex formula are difficult to share with any audience beyond fiscal experts. In addition, efforts in least developed countries have shown that even simple formula may require updated data, which are difficult to generate.

The design of intergovernmental grants is highly controversial. Although in many least developed countries the overall amount of transfers is still minimal, controversy focuses more on the *degree of conditionality* in order to assess the quality of decentralisation. In developing as well as industrialized countries, the conditions (and level of earmarking) attached to transfers do vary widely. At the starting point of decentralization earmarking is generally tight and activity specific. In a decentralised model, the long-term vision of fiscal decentralisation is a system with more discretionary powers. The challenge is how conditionality can be relaxed or reformulated such that they provide local authorities some degree of freedom in the allocation of the resources without increasing fiduciary risks and at the same time respecting national priorities.

In *least developed countries*, decentralisation has mostly taken the form of deconcentration. Policy documents give an unrealistic number of responsibilities to the districts, without supplying them with an adequate amount of finances. It is not always clear where exactly the responsibilities of central government end and tasks of local governments begin. In particular in francophone and lusophone Africa the overall amount of resources transferred to sub-national governments is low, not formula-driven and not predictable and data are lacking to feed even simple distribution formulae.

In those countries where intergovernmental transfers were substantially increased (mostly middle income countries such as South Africa or Colombia), a continued (or even increased) *Fiscal Dependency* is being observed. This occurs when (conditional or unconditional) transfers are fast increasing while locally generated revenues are not.

Notwithstanding the establishment of social investment and municipal development funds in many partner countries, as well as emerging vertical transfers for various purposes, there is a structural *shortage of funds for major capital investment at district level*. According to the observations of the author, donors have shown a certain preference for investing in social sectors (such as basic education, health and rural water) while other sectors are lagging behind.

There is consensus that it is important to establish *incentive structures* which respond to the scope and quality of local service delivery as well as local governance in general. A number of donors and some governments have tried to partially link access to development funds to performance by e.g. including some performance criteria in the formulae for intergovernmental fiscal transfers. Efforts have also been made to develop more complex systems of performance measurement, such as (i) performance contracts for local (and other) government staff (Rwanda) and (ii) Performance Management related to the Local government Unit (Philippines). These approaches are promising as they show political will to decentralize and award good local governance in responses. However, results in terms performance measurement are not yet reliable.

4 Options for improving Local Revenue Generation

Available evidence allied to best practice for fiscal decentralisation suggests that the percentage of local revenues collected compared to overall expenditures remains low

in many developing countries, due to (i) weak local revenue base in most African countries and lack of tax authority and lack of administrative capacity; (ii) concentration of locally generated revenue in the larger urban areas, (iii) Transfes and grants which lead to erosion of incentives to locally generate revenues, (iv) interfaces between weak local revenue base and other governance aspects.

Evidence was found for unexploited *local revenue potentials* with regard to Real Property Tax, and market fees and taxes. Revenue generation from services continues to have substantial potential but is presently weak. However, despite political and administrative decentralization, local governments are less active in the process of tax reform. Concerning property tax, there appears to be a lack of insight in the exact number and sizes of the properties, which is partly due to traditional property concepts and partly due to political manoeuvering.

There is consensus that LGs need a certain amount of *fiscal autonomy* in order to improve their revenues. However, Interpretation of the powers of LGs often rests with the central government, which makes local tax initiatives risky. Further, the phasing of and interfaces between different reform dimensions (autonomy versus capacity building for accountability) are sometimes controversial. Transparency with respect to budgets and accounts is regarded the heart of local government accountability. However, in many low income countries transparency in fiscal and financial affairs remains limited and/or financial information does not reach or is not understood by the general public.

Technically, the following administrative *weaknesses* apply to most African countries but also some more advanced countries: *Tax bases* of local governments are static, *Mechanisms for collecting* internal revenues are ineffective; appropriate *sanctions* or punishment for tax defaulters are absent. Most residents, especially traders, do not feel obliged to pay taxes. The co-operation and exchange of data between the LGs and other public institutions and state agencies seems not to function very well.

Based on cooperation programmes in e.g. Ghana and Tanzania, tax experts agree that greater emphasis shall be given to the *cost-effectiveness of revenue collection* and losses through corruption and tax evasion need to be reduced. To achieve these aims, there is generally a need for further *simplification* of the licence and fee structures by reducing the number of rates and coverage and avoid double taxation and conflicts with national development policies. Furthermore, uniform rates on agricultural taxes (crop cess) are necessary to minimise distortions.

A *real property tax*, based on the assessed value of all properties located in a given area, is generally regarded to having the highest tax potential at local level. The East African experience suggests that the primary obstacle to effective property taxation is not policy but *administration*. Property tax reform efforts in East Africa have sometimes favored a “valuation-pushed” strategy (Tanzania and Uganda in the early 1990s) and sometimes a more “collection-led” approach (Uganda now, Kenya). Experience indicates that success depends on a comprehensive improvement of several administrative practices rather than one specific aspect. Countries in Asia have made significant effort to improve RPT administration but also produced limited results while general fiscal management was not improved.

The adequacy of the approach chosen depends on the characteristic of the partner country. In the *Philippines* for example, the legal framework is comprehensive with

regard to tax autonomy: However, development partners complain that their support succeeded only in shifting the point of evasion from assessment to collection. Other interventions, particularly in the computerization of real property tax administration, increased collections but there was also a corresponding increase in expenditures.

Following previous experiments in other countries of the EAC, Rwanda in 2006 has declared *privatization of market tax collection* an official policy in order to improve efficiency and efficacy of the local fiscal administration. In contradiction to optimistic official forecasts a recent analysis found that privatization is rather complex and successful implementation goes far beyond routine implementation of a cabinet decision. Privatization of tax collection would bear considerable risks and probably not produce the expected results. Based on unrealistic fiscal potential analysis lump sum agreements might lead to an either inappropriate profit of the private tax collector and a high loss for the district or vice versa. It is argued that external factors determining the general conditions the districts have an impact on the revenue potential, not easy to be influenced and other constraints such as tax evasion and corruption requires reforms in public service in addition to tax administration. Experiences from other African countries (Uganda, Ghana, Mozambique) have raised similar doubts: Profit margins for private collector s were found to be mostly inadequate, resulting in no significant increase, but occasional decrease in public revenues. Monitoring for districts is apparently difficult.

5 Challenges for capacity building

Weak institutional capacity is often cited by central-government stakeholders in their arguments against fiscal decentralization. At any rate, where fiscal decentralization does take place, it almost always is accompanied by efforts, often funded by international donors, to strengthen institutional capacity at local levels.

Capacity development for local governments has often suffered from unclear institutional responsibilities. In most countries, the Ministry of Finance is in charge of PFM reforms, which are an essential requirement for fiscal decentralisation with limited fiduciary risk. On the other hand, the political advocacy for decentralisation as a whole is generally with the Ministry of Local Government. In this case, the Ministry in charge of decentralisation needs to have a strong coordinating mandate in order to comply with its crosscutting function. This is not generally given.

In those low-income countries, which are recipients of general budget support, capacity building in *Public financial Management* does generally receive a lot of attention, in order to alleviate fiduciary concerns. This is not the case with capacity building needs in other areas, which do equally require capacity building. National training needs assessments or action plans – if in place – are too general to promote reforms and best practices. In most countries, planning, citizen participation and service delivery are mainly supported by bilateral development projects or at best sector programmes but not comprehensive programme based approaches.

Despite PFM reforms ongoing in most countries, there is a lot of *room for capacity building* efforts to support PFM reform at LG level, referring not only to tax administration but the whole budget cycle and accounting. In the PRSP context, Medium Term Expenditure Frameworks have been introduced to central governments governments, but a meaningful roll-out to LGs is outstanding and requires a

predictable substantial flow of finance. Modern accounting practices (whether modified cash-based or accrual-based) also constitute a mayor change for LGs as most accounting staff were trained under a different system (if staff at local level is trained at all). Accordingly t*here is a huge need for retraining in order to meet requirements for transparent and complete budgets at LG level*.

***Manuals and guidelines* need to be updated and validated at national level. The impression of the author is that to date there is not much exchange of information between Anglophone and francophone reform supporters. It might be worthwhile to systematically check and compare tools and training content used to support PFM reform in different countries and give more attention to less strategic aspects such as filing and antivirus protection.**

While support to (participatory and other) to LG development planning has received a lot of attention from bilaterals (mainly through support to municipal and regional development plans), *project management skills* of LGs have not been upgraded accordingly. This area was not essential, while most LGs had no funds to implement major investment projects on their own and donor-sponsored projects were mostly implemented by the respective donors.

With the subsequent devolution of responsibilities as well as funds to local governments, this has changed fundamentally. Municipal development funds (= third generation social funds, e.g. in Central America) as well as the emerging national LG financing systems (such as ANICT in Mali, Fonds Permanent in Burkina Faso, CDF in Rwanda) regard cities and municipalities as owners of their investment projects, whose costs should also appear in LG budgets.

However, most local governments of most developing countries (except for the major cities and urban LGs of middle income countries) are not in a condition to fully manage project cycles without support, due to lack of skilled staff, lack of experience or high turnover. Weaknesses relate to linking plans to budgets, conducting feasibility studies for investments, procurement and tender evaluation, contract management, supervison of works, internal audit, operation and maintenance of related services.

As a response, in francophone Africa, municipalities can delegate part of the project management to a consultant, who is paid by the fund/financing system (maîtrise d'ouvrage délégué); the modality has proven to be efficient with regard to the completion of works but does not cover subsequent phases of operation and maintenance; further, according to the experience of the author, the difference between maîtrise d'ouvrage and the delegation mode is not always clear to LGs. This means, that transfer of knowledge may not be effective.

In Central America, during the 90s trainings to local communities were conducted to enhance participation in the maintenance of structures; the approach was successful in increasing transparency during project implementation but success with regard to sustainability was limited. Since a couple of years, municipalities have been assisted to establish multidisciplinary technical teams to manage investment projects, supported by a regressive financing of salaries; this approach was successful in a period of growing transfers to municipalities, which facilitated the take-over of staff by LGs.

6 Sub-national Borrowing as an Option for the Fittest

Sub-national borrowing is discussed as an option for infrastructure financing. Through the often externally funded preferential loans, access of municipalities to *financial markets* shall be improved and investment in infrastructure speeded up, which is essential for improving living conditions. In addition it is argued that loans contribute to transparency. However, in many countries, particularly in parts of Asia and Latin America, the first generation of municipal loans has not been sustainable.

As a result, most middle income countries have strictly regulated municipal access to loans and introduced indicators to assess the debt potential. Based on these grounds, at least *25 developing countries* started to (re-) engage with sub-national borrowing.. In this context national state guarantees for sub-national debt are generally abolished. Additionally, regulations on budgeting, accounting, reporting, and supply chain management impose discipline on municipalities. Municipal borrowing in South Africa was in fact found to impact positively on local governance in terms of transparency, accountability and financial management.

The selection of particularly *poor municipalities* for loan financing is obviously <u>not</u> a viable option for a loan programme as all loans must be financially viable. In poorer and more *rural municipalities* in developing countries, there are no historical records about the capacity and willingness to connect and pay, as services are established for the first time. This makes calculations more risky for both the lender and the borrower. Further, loans for water and sewerage projects are restricted to the ULB's willingness to review user fees and often cost-recovering charges are considerably higher than the existing water ones. Deposit payments for water and sewage house connections are an additional burden for low-income households, which has to be considered.

As a result, municipal loans can complement but not replace or reduce intergovernmental fiscal transfers, which are required to introduce those reforms, which may lead to accessing capital markets. However, it is worthwhile to look at the experience of the Indian State of Tamil Nadu, which is applying a clever mix of moderate government subsidies with financial market tools to provide reform incentives for revenue generation and create a *soft equalization bonus* for poorer municipalities

The *market for municipal bonds* is still nascent with several constraints to growth to be overcome: On the demand side, most local governments have no or only rudimentary understanding of this financing mechanism and there is no secondary market for bonds. Accordingly, municipal experience with bonds is even more limited than experience related to municipal borrowing.

However, for municipalities which are already borrowing, a *diversified debt portfolio* is an advantage of bonds. Other benefits of bonds are their greater flexibility since a city can eventually buy back debt at a lower rate on the bond market, and their ability to catalyze further investment. In the long run bonds may be *cost effective*, if they are launched with a good rating. However, this advantage depends on the current situation of both, bonds and loan markets.

Several countries have launched initiatives to make the launching of bonds more attractive to both municipalities and investors. Two mechanisms are to be mentioned in this regard: (i) The Local Government Unit Guarantee Corporation (LGUGC) in the Philippines, (ii) The Pooling of Bonds in the South Indian State of Tamil Nadu. Results

are still outstanding. In general, pooled bonds are not prime tool to enhance good governance. Bonds may reward responsive local policies and project management to a lesser extent and may mainly relate to conditions on the bond markets in general.

7 Involvement of Private Providers as a way forward

From a local governments' point of view, the major advantage of PSP lies in its nature as an off-budget mechanism for mobilising funds that are not available in the public budgets and as an additional income source for the local budget in the short run. The overall attitude of local governments towards private participation in infrastructure as well as experience is varied between countries. In Indonesia, for instance, foreign investors were particularly welcome, while in several Latin American countries, the topic of private sector participation in water supply is highly politicized (e.g. Bolivia, Nicaragua) due to the failure of international contracts. The experience of a higher middle-income country (Colombia) in the water and sanitation sector indicates that municipal water utilities as well as private ones can provide satisfactory service at reasonable cost, if a strong state run oversight agency is in place.

The challenge is that local administrations overestimate the willingness of private investors to engage in long-term projects with higher operational risks and underestimate the complexity of contracts and risk-sharing arrangements for PSP in infrastructure projects with uncertain revenue streams. Some investors have negotiated a predefined rate of return, which could later not be achieved, as systems required more investment and consumers more protection than anticipated.

In order to avoid the inherent risk of taking over the management of an existing network the most popular model of PPP is *"Build-Operate-Transfer"*. Local governments prefer the BOT-model as it is simple in structure, mode of operation and control of results. Obviously, this relatively simple BOT-model can be used for commercial projects only and not for basic infrastructure projects with uncertain revenue streams.

Further, a recent study on Indonesia found that the PSP-approval process is particularly prone to *corruption practices*. Again, the relevance of this point depends on the overall quality of local financial governance, which goes much beyond the specific cooperation modality.

In countries, where local financial governance is not strong enough to deal with complex contractual arrangements, there are several micro-level success stories for the application of *gradual approaches,* which relate to (i) doing the easiest things first and (ii) going for gradual involvement of private providers, even If comprehensive privatisation or management contracts are not. An example for this is the the fee-based involvement of local private craftsmen in the maintenance of rural public water supply systems in Nicaragua and Burkina Faso. In the Indian State of *Tamil Nadu*, a Grant Fund has been established to explicitly assist ULBs in the preparation and / or supervision of more complex and innovative projects such as PPPs and BOTs.

Conclusions and Recommendations

On the modalities of decentralization

Decentralisation implementation – though starting from deconcentration – shall proceed to the *devolution* of tasks, transforming local governments into autonomous institutions, clearly stating their exact responsibilities and sources of income.

Decentralisation should lead to *planning* procedures that are based on perceived needs in the district and respect national policies (not vice versa). Responsibilities have to be made clear and a monitoring system implemented, corresponding to a performance-based approach.

Both traditional authorities / power structures and communication channels should be considered, in order to stimulate *accountability*. Mechanisms for citizen consultation and management of complaints by elected authorities should be established in order to improve performance of and respect towards assembly members.

Local government must be entitled to establish fees for *services* on a cost-recovery basis in order to be able to generate income from potentially profitable services

Central governments should consider introducing policies that guarantee desired minimum levels of provision for certain services at the local level. National standards can be enforced in several ways such as enticing local governments with a matching grant program. National standards may also be enforced by denying full receipt of block grant money unless certain minimum expenditures and provisions established by the central government are met.

> ***Development partners as well as governments need to understand that (i) implementation of national policies at local level requires a well-organised dialogue instead of the often practiced top-down approach and (ii) districts need a new type to advisory services to be able to balance respect to national policies, felt local needs and technical sector norms in a professional and cost-effective way and produce comprehensive planning documents accordingly.***
>
> ***As these services mostly require comparatively huge investments with long maturity periods and are highly relevant for health as well as environmental purposes, governments and donors should consider establishing adequate financing modalities (whether on a grant or on a loan basis).***
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> ***Development partners should support joint comprehensive sector reviews of the housing, education, sanitation, health, and social welfare sectors, which are particularly relevant for service delivery at sub-national level to increase the efficiency of operations as well as public expenditures, before promoting joint modalities of financing***

Matching principle

***In order to avoid imbalances, it is important that the budget shares of sub-national governments match the amount of functions assigned*. In the desire for decentralization the matching principle has been neglected and imbalances created, which tend to overburden LGs (either with regard to the tasks devolved or**

with the money to spend). Given the capacities and human resources at LG level, it is generally unrealistic to expect that all possible activities, which fall under the mandate of districts, can be decentralised at short term. In view of limited administrative capacities, it may be considered to let districts focus on a selected set of activities for which they are mandated and bear direct responsibility i.e. to let them focus on the implementation of activities from own resource and the decentralised budget.

Imbalances imply risks for the benefits of decentralisation to come true. There is little evidence of donors conditioning support in this regard. Particularly, in the least developed countries, during the first generation of PRSP the spending on the social sectors was a major concern but development partners did not follow up whether spending was done on national and sub-national levels.

> ***Development partners should actively follow up the overall amount of funds available to LGs for the compliance with their functions and condition (budget) support in this regard.***

***To the extent possible, services provided by government should be financed by user charges and fees*. Given the limited capacity of districts to raise own revenues, over the short to medium term, the majority of service delivery will be financed through a series of earmarked grants, whilst block transfers will fund administrative functions at the districts and provide discretionary funds to supplement earmarked allocations to service delivery.**

> ***Development partners should support establishing a closer link between fees and services rather than requesting increased discretionary powers, before this condition is met.***

Legal framework

In order to minimize confusion with regard to roles, functions and powers, a specific legal framework for fiscal decentralization is required, which consists of the following *key elements*: a local-government code, local government revenue legislation including a tax code, a new budget law and a treasury law which need to be consistent with the preferred structure of fiscal federalism in the country. If increased accountability is to be achieved, it is preferable that budget laws prescribe transparent procedures for budget formulation and discussion at the local level.

> ***Development partners should extend their support to establishing legal decentralisation frameworks by explicitly referring to the institutionalisation of best practices in terms of transparency, e.g. posting budgets and local revenues, voting on or public debate of budgets, and periodic budget reviews at the local level. As for policy dialogue on treasury regulations it is important not to discourage effective management by local officials for the sake of central government control.***

Intergovernmental fiscal relations

In order to increase predictability, transfers should be based on strict *formulae*, targeting transfers to specified criteria, such as population size, surface area, poverty

levels, local fiscal effort and others. Rules of transfer systems should be transparent and give incentives for good fiscal performance. LGs should not be penalized for raising additional revenues, by reducing grants. All current direct transfers (including conditional transfers by line ministries to LGs) should be included into the decentralised budgets.

Central government should give more incentives to the local administration to make full use of their tax potential. Whichever mode of horizontal allocation is used, the access to the funds by districts could be made subject to meeting one or more particular conditions that are related to performance. This can be activity or sector specific performance or generic performance. There should be incentives and disincentives based on performance for revenue collectors as well as the management staff responsible for the revenue generation at the district.

If capacity allows for decentralization to progress from deconcentration to devolution, it is desirable that (i) Conditions will be gradually relaxed and (ii) Un-conditional grants will increase at the expense of the conditional grants, both in accordance with capacity at sub-national level.

> ***In view of the embryonic state of intergovernmental fiscal relations in most least developed countries development partners should focus their joint efforts to (i) support road maps for and monitor the increase and predictability of the amounts transferred under either modality, (ii) support establishing control mechanisms at sub-national level, (ii) assist to improve availability of adequate data for supplying the transfer formula.***
>
> ***All Contributions from development partners –that constitute a substantial part of the public sector budget in highly aid dependent countries - should be included in the calculation of equalization transfers and partners should provide full information in this regard***

Local Revenue generation

National Governments who want to increase local revenues in a sustainable and efficient way, must first establish a clear policy framework. If this is given, LGs are to focus on those sources of revenue, which provide a *significant potential* and a reasonable cost-benefit ratio. There is consensus to focus on (i) real property tax, (ii) licences and fees that can be levied and collected by local administrations, in particular market fees and taxes and (iii) other fees for services (water and sanitation, electricity)

***Policy objectives* for fiscal decentralisation should be scaled back to realistic aspirations and policies be congruent with the real situation in many LGs with limited tax bases and limited revenue raising potential. The legal framework should be adjusted to increase (i) the tax base, (ii) tax yields and (iii) collection capacity at the local and central levels. It should be guaranteed (institutionally or otherwise) that local governments receive their part of the locally generated revenues in a timely manner without delays and without diversion. Double taxation of the same purpose should be avoided (e.g. parallel existence of RPT and a residential tax)**

One major *administrative problem* today for many LG councils is their inability to collect fully the revenue due to them. Specific issues to be addressed in this context are to (i) strengthen general financial management, (ii) enhance taxpayers' compliance and to (iii) improve the accountability of tax collectors and councillors.

In order to enhance *real property taxes*, collection of basic rates, and the costs incurred with solid waste collection and treatment, as well as drainage maintenance, should be collected by means of the property tax. Poverty concerns in this regard should be addressed by (i) establishing a very low or zero property tax for informal dwellings but proceed with registration and collection of basic service fees, (ii) promoting / maintaining low-cost solutions in water and sanitation (e.g. public standpipes, public toilets, public showers) for those groups of the population who cannot afford to connect to urban networks, (iii) offer payment by installment for connection fees. Differential rates of property tax on private and commercial properties should be applied

***Privatizing parts* of local revenue collection could be a viable response to corrupt and inefficient public structures, but can't replace a weak administration. Private tax collection still requires a strong and transparent administration to minimize the loss from the contributions of the population.**

> ***Development partners should build a common position with regard to tax sharing and fiscal autonomy in each partner country, based on the experience of donors and specific framework conditions given***
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> ***Development partners should support capacity building in order to specify administrative versus political weaknesses***
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> ***Development partners and Central governments should assist LGs to overcome difficulties to levying and adjusting unpopular taxes; e.g. property evaluation may be carried out by the central tax administration or by a separate valuation agency: Partners and central governments may assist in introducing appropriate IT solutions to establish complete records of commercial and residential properties***
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> ***Development partners may build financial incentives for LGs to improve RPT collection and promote good transparency practices (e.g.Giving publicity to the "Top Ten Defaulters") as part of their operations to support LG financing***
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> ***If privatization of collection is promoted this has to respond to be embedded in other initiatives to improve administrative capacities and monitoring, in particular incentives for tax collectors and sensitization of tax payers***

Capacity Building

In general terms, development partners who favour general and sector budget support, have not given much attention to the need for Capacity Building and rather argue in favour of increasing discretionary non-conditional transfers to districts, allowing them to learn from experience. According to this philosophy, some funds have been set up as financing mechanisms, without caring for technical departments and support staff to guide districts (which proved to be an expensive learning process). On the other hand, francophone governments and donors from this

administrative context may give effective technical support to LGs but do really hesitate to hand over funds.

> ***Development partners should a*****cknowledge that fiscal decentralisation is a long term process, which depends on political will as well as technical expertise and requires c*****apacity building as well as monitoring at all government levels (including the local level, nation wide).***
>
> ***Development partners should d*****efine realistic phases for support and realistic transition periods in line with the national reform process; they *****should classify the need for support according to the levels of intervention, in order to define target groups and viable approaches for harmonized CB approaches***
>
> ***Development partners should a*****gree on best practices to be promoted in each of these areas (exchange these practices among the donors)**
>
> ***Development partners should e*****ncourage governments to establish specific CB grants (as part of the intergovernmental transfers or in addition)**

Municipal Borrowing

Regardless of the degree of local fiscal autonomy in a country, *central governments* will always need to carefully monitor and project local-government finances. All types of sub-national borrowing should be closely regulated by the central authorities. Besides enforcing the debt limits established by the law, there should be a certification process of the conditions for any bond issues. Loan and bond financing are viable options for a considerable number but not all local governments in all countries.

Access to capital markets requires a sound *condition of municipal finance*, in order to be able to repay the loan. It is rather a second step, following reforms in municipal financial management. Given the limited interest of the private sector to engage in municipal borrowing, there is considerable merit to the establishment of a subnational development fund to promote lending to subnational governments for long-term capital investment.

Grant and loan financing for infrastructure should be clearly defined and separated, and interest rates of development loans in consideration of the prevailing national market conditions, in order to avoid disturbances of the capital market. If special conditions are offered to poorer municipalities, conditionalities should be set for the implementation of FM reforms and improvement of own revenues. The central government *as a general policy* should not act as guarantor of regional and local government debt issues.

Municipal bond financing can be cost-effective for larger and resource rich municipalities but is rather complex as it requires a certain scale of experience and operations and success also depends on conditions of general markets for bonds.

> ***Development partners should support for reforms in PFM before promoting municipal loans and assist in the establishment of fiscal screening and rating of municipalities (which may be part of or in addition to a LG performance measurement system)***
>
> ***Development partners should not mix loan and grant financing; If grant funds are provided in the area of municipal loans, use them for specific purposed, e.g.***

(i) financing or awarding of reforms, which will facilitate access to capital markets, (ii) as guarantee capital to establish lending institutions with suitable modalities

Involvement of private providers

Privatisation **of pubic services may be a viable option for improving the fiscal space of municipalities with (i) a strong oversight capacity, (ii) a strong negotiation capacity for fair and transparent contracts, (iii) local markets, which are profitable enough to generate a constant stream of revenue. Quite obviously, this is not a typical situation for many municipalities in developing countries (and even not for industrialised countries); PPP should thus be regarded as a complex modality, which requires a thorough assessment of the local market, feasible revenue potential and financial interests involved before taking decisions.**

If the above-mentioned conditions are not met or privatisation of a politically sensitive issue, it is recommended to promote *gradual approaches*, including e.g. the following elements: (i) get people used to contribute financially at all before promoting cost recovery and focus on fees and charges, which are easy to collect, (ii) Involve private providers for specific tasks on a pilot basis

User charges **are generally a sensitive issue and may also contradict efforts for poverty reduction. It is therefore recommended to (i) first improve service and afterwards adjust charges (not vice versa), (ii) define and publicly discuss a transparent structure of user charges (not waiting for a private provider to implement a controversial scheme), (iii) establish adequate modalities for low income to benefit from services (e.g. cross subsidization or supply of low cost services)**

Development partners may assist in developing standard contracts for delegation of specific tasks such as maintenance to private providers

Development partners should **deal with PPP as a technical issue, which requires thorough assessment before taking decisions or making recommendations; a confrontation between the PPP concept and the rights based approaches, Discuss evaluation criteria in a transparent manner**

Development partners should a**nalyse experience with privatisation in their own country before making recommendations to Africa. If best practices are evident, they should assist partner countries in developing and assessing implementing arrangements (contracts with private providers), which LGs are able to follow up**